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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

REG-100420-03

RIN 1545-BB90

Safe Harbor for Valuation Under Section 475.

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document sets forth an elective safe harbor for dealers in securities, dealers in commodities, and traders in securities and commodities that permits these taxpayers to make an election pursuant to which the values of positions reported on certain financial statements are the fair market values of those positions for purposes of section 475 of the Internal Revenue Code. This safe harbor attempts to reduce the compliance burden upon taxpayers and to improve the administrability of the valuation aspect of section 475 for the Internal Revenue Service. This document also provides a notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by August 22, 2005. Outlines of topics to be discussed at the public

hearing scheduled for September 15, 2005 at 10 a.m. must be received by August 23, 2005.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-100420-03), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:LPD:PR (REG-100420-03), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue N.W., Washington, DC, or sent electronically, via the IRS Internet site at [www.irs.gov/regs](http://www.irs.gov/regs) or via the Federal eRulemaking Portal at [www.regulations.gov](http://www.regulations.gov) (IRS-REG-100420-03).

FOR FURTHER INFORMATION CONTACT: Concerning submissions of comments, the hearing or to be placed on the building access list to attend the hearing, Treena Garrett at (202) 622-7180; concerning the proposals, Marsha A. Sabin or John W. Rogers III (202) 622-3950 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

**Paperwork Reduction Act**

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collection of information should be sent to the **Office of Management and Budget**, Attn: Desk Officer of the Department of

Treasury, Office of Information and Regulatory Affairs,  
Washington, D.C. 20503, with copies to the **Internal Revenue  
Service**, Attn: IRS Reports Clearance Officer,  
SE:W:CAR:MP:T:T:SP, Washington, D.C. 20224. Comments on the  
collection of information should be received by July 25, 2005.  
Comments are specifically requested concerning:

Whether the proposed collection of information is necessary  
for the proper performance of the functions of the IRS,  
including whether the information will have practical utility;

The accuracy of the estimated burden associated with the  
proposed collection of information (see below);

How the quality, utility, and clarity of the information to  
be collected may be enhanced;

How the burden of complying with the proposed collection of  
the information may be minimized, including through the  
application of automated collection techniques or other forms of  
information technology; and

Estimates of capital or start-up costs and costs of  
operation, maintenance, and purchase of services to provide  
information.

The collection of information in these proposed regulations  
is in §1.475(a)-4(f)(1) and §1.475(a)-4(k). This information is  
required by the IRS to avoid any uncertainty about whether a  
taxpayer has made an election and to verify compliance with

section 475 and the safe harbor method of accounting described in §1.475(a)-4(d). This information will be used to facilitate audits and to determine whether the amount of tax has been calculated correctly. The collection of the information is required to properly determine the amount of income or deduction to be taken into account. The respondents are sophisticated dealers or traders in securities or commodities.

Estimated total annual recordkeeping burden: 49,232 hours.

Estimated average annual burden per recordkeeper: 4 to 6 hours.

Estimated number of recordkeepers: 12,308

Estimated frequency of recordkeeping: annually

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents may be material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

## **Background**

This document contains proposed amendments to 26 CFR Part 1 under section 475 of the Internal Revenue Code (Code). Section 475 was added to the Code by section 13223(a) of the Omnibus Budget Reconciliation Act of 1993 (Public Law 103-66, 107 Stat. 312). Section 475(a) generally provides that the securities held by dealers in securities shall be valued as of the last business day of the year at fair market value. Section 475(g) provides that the Secretary shall prescribe regulations as may be necessary or appropriate to carry out the purposes of section 475. The legislative history of section 475 indicates that, under this authority, the Secretary may issue regulations to permit the use of valuation methodologies that reduce the administrative burden of compliance on the taxpayer but clearly reflect income for federal income tax purposes. On May 5, 2003, the Treasury Department and the IRS published in the **Federal Register** an Advance Notice of Proposed Rulemaking (Safe Harbor for Satisfying Certain Statutory Requirements for Valuation under Section 475 for Certain Securities and Commodities)(REG-100420-03)[68 FR 23632](the ANPRM); Announcement 2003-35, 2003-1 C.B. 956 (see §601.601(d)(2)). The ANPRM solicited comments on whether a safe harbor approach using values reported on an applicable financial statement for certain securities may be used for purposes of section 475. The ANPRM set forth a

possible safe harbor for valuing these securities and asked for comments on various aspects of such a safe harbor.

## **Explanation of Provisions**

### Overview

Section 475(a) requires dealers in securities to mark their securities to market. Sections 475(e) and (f) allow dealers in commodities and traders in securities or commodities to elect similar treatment for their securities or commodities. If the security or commodity is inventory, it must be included in inventory at its fair market value, and if it is not inventory and is held at the end of the taxable year, gain or loss is recognized as if the security or commodity had been sold for its fair market value on the last business day of the taxable year.

Although the term "fair market value" has a long-standing and well-established meaning within the tax law, it is sometimes difficult to determine the fair market value of certain securities and commodities, particularly those that have no comparable sales. This has impeded the efficient administration of the mark-to-market system under section 475. Consequently, with a view to improving the administrability of the valuation requirements of section 475, the Treasury Department and the IRS issued the ANPRM, which set forth some principles upon which a safe harbor for valuation could be constructed. Using these principles, and incorporating a number of comments received from

the public, these proposed regulations set forth a safe harbor for valuing securities and commodities under section 475.

#### Safe Harbor

The safe harbor generally permits eligible taxpayers to elect to have the values that are reported for eligible positions on certain financial statements treated as the fair market values reported for those eligible positions for purposes of section 475, if certain conditions are met. The safe harbor is based upon the principle that if the mark-to-market method used for financial reporting is sufficiently consistent with the mark-to-market method required by section 475, then the values used for financial reporting should be acceptable values for purposes of section 475, even if those values are not fair market values under general tax principles. To ensure minimal divergence from fair market value under tax principles, these proposed regulations impose certain restrictions on the financial accounting methods and financial statements that are eligible for the safe harbor and also require certain adjustments to the values of the eligible positions on those financial statements that may be used under the safe harbor.

The safe harbor requires that financial statement values be adjusted to comply with the requirements of section 482 or section 482 principles when applicable. For example, section 482 principles may require the revision of estimates of future cash

flows used in valuing certain financial instruments to reflect the appropriate arm's length pricing of inter-branch transactions as of their origination date. In addition, these proposed regulations do not alter the treatment of interest expense. See sections 861 and 882 and regulations thereunder.

#### Eligible Taxpayers and Eligible Positions

The safe harbor is available to any taxpayer subject to the mark-to-market regime under section 475, whether the taxpayer is a dealer in securities under section 475(a), a dealer in commodities under section 475(e), or a trader in either securities or commodities under section 475(f). The Commissioner will issue a revenue procedure that lists the types of securities and commodities that are subject to the safe harbor. It is anticipated that the revenue procedure will apply to every security position and every commodity position subject to mark-to-market under section 475. Comments are requested as to whether any types of securities or commodities should be excluded from the safe harbor.

It is important to note, however, that the valuation methodology under the safe harbor applies only for positions that are properly marked under section 475. The safe harbor only addresses valuation and does not expand or contract the scope of application of section 475. For example, if a security is not marked under section 475 because it has been identified



as held for investment, then under the safe harbor it may not be marked for federal income tax purposes even though it is properly marked on the financial statement in accordance with U.S. Generally Accepted Accounting Principles (U.S. GAAP). Similarly, if a security is not marked on the applicable financial statement because it is a hedge but section 475(a) applies because the security was not identified as a hedge, then the security must still be marked under section 475.

#### Eligible Method

To qualify for the safe harbor, a financial accounting method must satisfy certain basic requirements. First, it must mark eligible positions to market through valuations made as of the last business day of each taxable year. Second, it must recognize into income on the income statement any gain or loss from marking eligible positions to market. Third, it must recognize into income on the income statement any gain or loss on disposition of an eligible position as if a year-end mark occurred immediately before the disposition. Fourth, it must arrive at fair value in accordance with U.S. GAAP.

In addition to the basic requirements, the safe harbor also imposes certain limitations that ensure minimal divergence from fair market value. Under the first limitation, which applies only to securities and commodities dealers, except for eligible positions that are traded on a qualified board or exchange (as

defined in section 1256(g)(7)), the financial accounting method must not result in values at or near the bid or ask values, even if the use of bid or ask values is permissible in accordance with U.S. GAAP. This limitation is based upon the business model for derivative contracts held by dealers in those derivatives, the model underlying most of the public comments received in response to the ANPRM.

According to the comments, dealers seek to capture and profit from bid-ask spreads by entering into positions that, in the aggregate, offset each other. The bid-ask spread contains the dealer's profit and compensates the dealer for all risks and expenses. The origination of such a balanced portfolio may, therefore, be seen as creating a synthetic annuity, with a value that is largely immune from market-related changes in the values of the component securities. For these eligible positions, such as interest rate swap contracts, use of bid or ask values approximates realization accounting and, therefore, fails to cause recognition of the present value of the synthetic annuity in the taxable year that the annuity is created. Consequently, the valuation method described in §1.471-4(a)(1) generally fails to satisfy the limitation set forth in paragraph (d)(3)(i) of these proposed regulations.

The Treasury Department and the IRS request comments on whether dealers in commodities and traders in either securities

or commodities operate under different business models and on how the rules set forth in these proposed regulations should be modified, if at all, to accommodate those business models.

Under the second limitation, if the method of valuation consists of determining the present value of projected cash flows from an eligible position or positions, then the method must not take into account any cash flows of income or expense that are attributable to a period or time before the valuation date. This limitation ensures that items of income or expense will not be accounted for twice, first through current realization and then again in the mark.

Under the third limitation, no cost or risk is accounted for more than once, either directly or indirectly. For example, a financial accounting method that allows a special adjustment for credit risk generally satisfies this limitation. It would not satisfy this limitation, however, if it computed the present value of projected cash flows using a discount rate that takes into account any amount of credit risk that is also taken into account by the special adjustment. Thus, if a dealer in securities enters into an interest rate swap contract with a counterparty with a AA/aa rating, taking credit enhancement and netting agreements into account, then the dealer cannot take a special adjustment to the value of the contract for all of the risk between a counterparty with a risk-free rating and the

actual counterparty if the dealer determines the present value of projected cash flows from the contract using a mid-market swap curve based upon the LIBOR AA rate. The Treasury Department and the IRS understand, however, that there may be degrees of credit quality within an established rating level, such as AA/aa, and that valuation methodologies used currently may reflect these nuances in credit quality. Accordingly, a credit adjustment reflecting these nuances may satisfy this limitation.

#### Election and Revocation

The election to use the safe harbor is made by filing a statement with the taxpayer's timely filed Federal income tax return for the taxable year for which the election is first effective. The statement must declare that the taxpayer makes the safe harbor election for all of its eligible positions. In addition to any other information that the Commissioner may require, the statement must describe the taxpayer's applicable financial statement for the first taxable year for which the election is effective and must state that the taxpayer agrees to timely provide upon the request of the Commissioner all information, records, and schedules required by the safe harbor. The election continues to be in effect for all subsequent taxable years unless it is revoked.

A taxpayer cannot revoke the election without the consent of the Commissioner. The Commissioner, however, can revoke the election if the taxpayer fails to comply with any of the recordkeeping and production requirements and cannot show reasonable cause for the failure, the taxpayer ceases to use an eligible method, the taxpayer ceases to have an applicable financial statement, as described below, or the taxpayer holds a de minimis quantity of eligible positions that are subject to the safe harbor. No revocation is necessary if the taxpayer ceases to qualify as an eligible taxpayer, or section 475 does not otherwise apply, because the safe harbor may only be used to determine values and cannot be used unless section 475 applies. Once revoked by either the Commissioner or the taxpayer, neither the taxpayer nor any of its successors may make the election for any taxable year that begins before the date that is six years after the first day of the earliest taxable year affected by the revocation without the consent of the Commissioner.

#### Applicable Financial Statements

Not all financial statements qualify under the safe harbor. Consequently, these proposed regulations set forth a system that enables a taxpayer to determine which one of its financial statements, if any, may be used when applying the safe harbor.

Three categories of financial statements qualify under the safe harbor and are set forth in order of priority, from highest

to lowest. In the first and highest category are those financial statements that must be filed with the Securities and Exchange Commission (SEC), such as the 10-K and the Annual Statement to Shareholders. In the second category are those financial statements that must be provided to the Federal government or any of its agencies other than the IRS. In this category are statements filed by foreign-controlled financial institutions engaged in trade or business within the United States who report their mark-to-market results to the Federal Reserve or the Office of the Comptroller of the Currency. In the third category are certified audited financial statements that are provided to creditors to make lending decisions, that are provided to equity holders to evaluate their investment, or that are provided for other substantial non-tax purposes and are reasonably anticipated to be directly relied on for the purposes for which the statements were created. For a financial statement described in any of the three categories above to qualify as an applicable financial statement, it must be prepared in accordance with U.S. GAAP. If a taxpayer has two statements in the same category, each of which would qualify under the safe harbor, then the statement that results in the highest aggregate valuation of eligible positions is the only financial statement that may qualify for the safe harbor.

Statements filed with the SEC provide a high degree of confidence that the values used on those statements reflect reasonable approximations of fair value. Consequently, there are no additional business use requirements for those statements. For the second category (statements filed with other agencies of the Federal government) and the third category of statements (the other certified audited financial statements), this degree of confidence is ensured by requiring some substantial non-tax use in the taxpayer's business. This determination of use must take into account whether the taxpayer's reliance on the values exposes the taxpayer to material adverse consequences if the values are incorrect. Accordingly, the safe harbor requires that the values for eligible positions contained in these financial statements be used by the taxpayer in most of the significant management functions of all or substantially all of its business. This use includes activities such as senior management review of business-unit profitability, market risk measurement or management, credit risk measurement or management, internal allocation of capital, and compensation of personnel but does not include either tax accounting or reporting the results of operations to other persons. Significance of use is tested by examining all the facts and circumstances in light of the stated purpose of the business use requirement.

The IRS and Treasury understand that some dealers maintain internal books of account, not prepared in accordance with U.S. GAAP, for separate segments of their business and that these internal books of account may include a charge to each operating segment of an internal "cost of carry" calculated in the manner of interest (and the derivatives dealer book may be treated as a separate business segment for that purpose). The purpose of this cost-of-carry charge is to assess profitability or to reflect the cost of capital in maintaining the positions held in that business segment. The amounts so charged do not reduce the fair value of eligible positions on a balance sheet prepared in accordance with U.S. GAAP. The maintenance of these segmented accounts, which may apply an accounting approach that does not qualify as an eligible accounting method, does not prevent some other financial statement prepared in accordance with U.S. GAAP from qualifying as the taxpayer's applicable financial statement.

#### Record Retention and Production; Use of Different Values

The safe harbor can be administrable only if the IRS can readily verify that the values used on financial statements are also appropriately used on the Federal income tax return. Consequently, recordkeeping and record production are critical to the safe harbor. These proposed regulations provide specific requirements for the types of records that must be maintained



and provided to enable ready verification. In general, electing taxpayers must clearly show: (1) that the same value used for financial reporting was used on the Federal income tax return; (2) that no eligible position subject to section 475 is excluded from the application of the safe harbor; and (3) that only eligible positions subject to section 475 are carried over to the Federal income tax return under the safe harbor. These proposed regulations outline what records must be retained and produced, including certain forms and schedules filed with the Federal income tax return, such as the Schedule M-1, "Net Income(Loss) Reconciliation for Corporations With Total Assets of \$10 Million or More," Schedule M-3, "Net Income(Loss) Reconciliation for Corporations With Total Assets of \$10 Million or More," and Form 1120F, "U.S. Income Tax Return of a Foreign Corporation." These proposed regulations also provide that the Commissioner may enter into an advance agreement with a taxpayer on how records are to be maintained and how long the records are to be retained. All of the necessary records must be retained as long as their contents may become material in the administration of any internal revenue law.

To encourage rapid examinations of the Federal income tax returns of electing taxpayers, these proposed regulations require that all necessary records be produced within 30 days after the Commissioner requests them. If the required records

are not provided as required, the regulations permit the Commissioner to use his discretion to: (1) extend the 30-day period; (2) excuse minor or inadvertent failures to provide the requested records; (3) require use of values that clearly reflect income but which are different from those used on the applicable financial statement; or (4) revoke the election (as described under "Election and Revocation" above) if a taxpayer does not demonstrate reasonable cause for the failure to maintain and produce the required records.

### **Special Analyses**

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It is hereby certified that the collection of information in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that it is anticipated that the safe harbor will be used primarily by dealers in securities that are financial institutions with a sophisticated understanding of the capital markets. Because section 475 is elective for traders in securities or commodities or dealers in commodities, some small businesses could qualify for the safe harbor if they make two voluntary elections: (1) an election to mark to market securities or commodities under section 475 and

(2) an election to apply the safe harbor. Because both elections are voluntary, it is unlikely any small business taxpayer who thinks the reporting and recordkeeping requirements are too burdensome will make these elections. Furthermore, the total average estimated burden per taxpayer is small, as reported earlier in the preamble. This is because most of the recordkeeping requirements do not require taxpayers to generate new records, but instead require records used for financial reporting purposes to be kept for tax reporting purposes. For all of these reasons, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

#### **Comments and Public Hearing**

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and the Treasury Department specifically request comments on the clarity of these proposed regulations and how they may be made easier to understand. All comments will be available for inspection and copying.

A public hearing has been scheduled for September 15, 2005 beginning at 10 a.m. in the Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restriction, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see "FOR FURTHER INFORMATION CONTACT" section of this preamble.

#### **Drafting Information**

The principal authors of these proposed regulations are Marsha A. Sabin and John W. Rogers III, Office of the Associate Chief Counsel (Financial Institutions and Products). However, other personnel from the IRS and the Treasury Department participated in their development.

#### **List of Subjects in 26 CFR Part 1**

Income taxes, Reporting and recordkeeping requirements

#### **Proposed Amendments to the Regulations**

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding an entry in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805 \*\*\*

Section 1.475(a)-4 also issued under 26 U.S.C. 475(g). \* \* \*

Par. 2. Section 1.475-0 is amended by:

1. Revising the introductory text.
2. Adding entries to the table for §1.475(a)-4.

The revision and addition reads as follows:

§1.475-0 Table of contents.

This section lists the major captions in §§1.475(a)-3, 1.475(a)-4, 1.475(b)-1, 1.475(b)-2, 1.475(b)-4, 1.475(c)-1, 1.475(c)-2, 1.475(d)-1 and 1.475(e)-1.

\* \* \* \* \*

§1.475(a)-4 Safe harbor for valuation under section 475.

- (a) Overview.
  - (1) Purpose.
  - (2) Summary of paragraphs.
- (b) Safe harbor.
  - (1) General rule.
  - (2) Scope of the safe harbor.
- (c) Eligible taxpayer.
- (d) Eligible method.
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- (3) Limitations.
  - (i) Bid-ask method.
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  - (iii) Accounting for costs and risks.

- (4) Examples.
- (e) Compliance with other rules.
- (f) Election.
  - (1) Making the election.
  - (2) Duration of the election.
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- (g) Eligible positions.
- (h) Applicable financial statement.
  - (1) Definition.
  - (2) Primary financial statement.
    - (i) Statement required to be filed with Securities and Exchange Commission.
    - (ii) Statement filed with a Federal agency other than the IRS.
    - (iii) Certified audited financial statement.
  - (3) Example.
  - (4) Financial statements of equal priority.
  - (5) Consolidated groups.
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  - (7) Certified audited financial statement.
    - (i) [Reserved.]
    - (j) Significant business use.
      - (1) In general.
      - (2) Financial statement value.
      - (3) Management of a business as a dealer or trader.
      - (4) Significant use.
  - (k) Retention and production of records.
    - (1) In general.
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      - (i) Reconciliation.
        - (A) In general.
        - (B) Values on books and records with supporting schedules.
        - (C) Consolidation schedules.
      - (ii) Instructions provided by the Commissioner.
        - (3) Time for producing records.
        - (4) Retention period for records.
        - (5) Agreements with the Commissioner.
        - (1) [Reserved.]
  - (m) Use of different values.

\* \* \* \* \*

Par. 3. Section 1.475(a)-4 is added to read as follows:

§1.475(a)-4 Safe harbor for valuation under section 475.

(a) Overview—(1) Purpose. This section sets forth a safe harbor that under certain circumstances permits taxpayers to make an election pursuant to which the values of positions reported on certain financial statements are the fair market values of those positions for purposes of section 475. This safe harbor is based on the principle that, if a mark-to-market method used for financial reporting is sufficiently consistent with the requirements of section 475 and if the financial statement employing that method has certain indicia of reliability, then the values used on that financial statement should be appropriate values for purposes of section 475. If other provisions of the Code or regulations require adjustments to fair market value, use of the safe harbor does not obviate the need for those adjustments. See paragraph (e) of this section.

(2) Summary of paragraphs. Paragraph (b) of this section sets forth the safe harbor. To determine who may use the safe harbor, paragraph (c) of this section defines the term "eligible taxpayer" for purposes of the safe harbor. Paragraph (d) of this section sets forth the basic requirements for determining whether the method used for financial reporting is sufficiently consistent with the requirements of section 475. Paragraph (e) of this section describes adjustments to the financial statement

values that may be required for purposes of applying section 475. Paragraph (f) of this section describes how to make the safe harbor election and the conditions under which the election may be revoked. Paragraph (g) of this section provides that the Commissioner will issue a revenue procedure that lists the types of securities and commodities that may qualify as "eligible positions" for purposes of the safe harbor. Using rules for determining priorities among financial statements, paragraph (h) of this section defines the term "applicable financial statement" and so describes the financial statement, if any, whose values may be used in the safe harbor. In some cases, as required by paragraph (j) of this section, the safe harbor is available only if the taxpayer's operations make significant business use of financial statement values. Paragraph (k) of this section sets forth requirements for record retention and record production. Paragraph (m) of this section provides that the Commissioner may use fair market values that clearly reflect income, but which differ from values used on the applicable financial statement, if a taxpayer fails to comply with the recordkeeping and record production requirements of paragraph (k) of this section.

(b) Safe harbor—(1) General rule. Subject to any adjustment required by paragraph (e) of this section, if an eligible taxpayer uses an eligible method for the valuation of



an eligible position on its applicable financial statement and the eligible taxpayer is subject to the election described in paragraph (f) of this section, the value that the eligible taxpayer assigns to that eligible position in its applicable financial statement is the fair market value of the eligible position for purposes of section 475, even if that value is not the fair market value of the position for any other purpose of the internal revenue laws. Notwithstanding the rule set forth in this paragraph, the Commissioner may, in certain circumstances, use fair market values that clearly reflect income but which are different than the values used on the applicable financial statement. See paragraph (m) of this section.

(2) Scope of the safe harbor. The safe harbor may be used only to determine values for eligible positions that are properly marked to market under section 475. It does not determine whether any positions may or may not be subject to mark-to-market accounting under section 475.

(c) Eligible taxpayer. An eligible taxpayer is a dealer in securities as defined in section 475(c)(1) and §1.475(c)-1, a dealer in commodities as defined in section 475(e), or a trader in securities or commodities as defined in section 475(f).

(d) Eligible Method—(1) Sufficient consistency. An eligible method is a mark-to-market method that is sufficiently

consistent with the requirements of a mark-to-market method under section 475. To be sufficiently consistent, the eligible method must satisfy all of the requirements of paragraph (d)(2) and paragraph (d)(3) of this section.

(2) General requirements. The method--

(i) Frequency. Must require a valuation of the eligible position no less frequently than annually, including a valuation as of the last business day of the taxable year;

(ii) Recognition at the mark. Must recognize into income on the income statement for each taxable year mark-to-market gain or loss based upon the valuation or valuations described in paragraph (d)(2)(i) of this section;

(iii) Recognition on disposition. Must require, on disposition of the eligible position, recognition into income (on the income statement for the taxable year of disposition) as if a year-end mark occurred immediately before such disposition; and

(iv) Fair value standard. Must require use of a valuation standard that arrives at fair value in accordance with U.S. Generally Accepted Accounting Principles (U.S. GAAP) as established by the Financial Accounting Standards Board.

(3) Limitations--(i) Bid-ask method. Except for eligible positions that are traded on a qualified board or exchange, as defined in section 1256(g)(7), the valuation standard used for

the applicable financial statement of an eligible taxpayer must not permit values at or near the bid or ask value.

Consequently, the valuation method described in §1.471-4(a)(1) generally fails to satisfy this paragraph (d)(3)(i). The restriction in this paragraph (d)(3)(i) is satisfied if a resulting value is closer to the mid-market value than it is to the bid or ask value.

(ii) Valuations based on present values of projected cash flows. If the method of valuation consists of projecting cash flows from an eligible position or positions and determining the present value of those cash flows, the method must not take into account any cash flows (income or expense) attributable to a period or time prior to the valuation date. In addition, adjustment of the gain or loss recognized on the mark may be required with respect to payments on notional principal contracts that will occur after the valuation date to the extent that portions of the payments have been recognized for tax purposes prior to the valuation date and appropriate adjustment has not been made for purposes of determining financial statement value.

(iii) Accounting for costs and risks-(A) General rule. In a determination of fair value, appropriate costs and risks may be taken into account, but no cost or risk may be accounted for more than once, either directly or indirectly. If appropriate,

the costs and risks that may be accounted for, include, but are not limited to, credit risk (appropriately adjusted for any credit enhancement), future administrative costs, and model risk. In the case of credit risk, an adjustment is implicit in computing the present value of cash flows using a discount rate greater than a risk-free rate. Accordingly, a determination of whether any further downward adjustment to value for credit risk is warranted, or whether an upward adjustment is required, must take that implicit adjustment into consideration.

(4) Examples. The following examples illustrate this paragraph (d).

Example 1. (i) A, a calendar year taxpayer, is a dealer in securities within the meaning of section 475(c)(1). A generally maintains a balanced portfolio of interest rate swaps and other interest rate derivatives, capturing bid-ask spreads and keeping its market exposure within desired limits (using, if necessary, additional derivatives for this purpose). A uses a mark-to-market method on a statement that it is required to file with the United States Securities and Exchange Commission (Securities and Exchange Commission or SEC) and that satisfies paragraph (d)(2) of this section with respect to both the contracts with customers and the additional derivatives. None of the derivatives is traded on a qualified board or exchange, as defined in section 1256(g)(7). When determining the amount of any gain or loss realized on a sale, exchange, or termination of a position, A makes a proper adjustment for amounts taken into account respecting payments or receipts. All of A's counterparties on the derivatives have credit quality ratings of AA/aa, according to standard credit ratings obtained from private credit rating agencies.

(ii) Under A's valuation method, as of each valuation date A determines a mid-market probability distribution of future cash flows under the derivatives and computes the present values of these cash flows. In computing these present values, A uses an industry standard yield curve that is appropriate for

obligations by persons with credit quality ratings of AA/aa. In addition, based on information including its own knowledge about the counterparties, A adjusts some of these present values either upward or downward to reflect A's reasonable judgment about the extent to which the true credit status of each counterparty's obligation, taking credit enhancements into account, differs from AA/aa.

(iii) A's methodology does not violate the requirement in paragraph (d)(3)(iii) of this section that the same cost or risk not be taken into account, directly or indirectly, more than once.

Example 2. (i) The facts are the same as in Example 1, except that A uses risk-free rates to discount the payments to be received under the derivatives. Based on information, including its own knowledge about the counterparties, A adjusts these present values to reflect A's reasonable judgment about the extent to which the true credit status of each counterparty's obligation, taking credit enhancements into account, differs from a risk-free obligation.

(ii) A's methodology does not violate the requirement in paragraph (d)(3)(iii) of this section that the same cost or risk not be taken into account, directly or indirectly, more than once.

Example 3. (i) The facts are the same as in Example 1, except that, after computing present values using the discount rates that are appropriate for obligors with credit quality ratings of AA/aa, A, based on information including its own knowledge about the counterparties, adjusts some of these present values either upward or downward to reflect A's reasonable judgment about the extent to which the true credit status of each counterparty's obligation, taking credit enhancements into account, differs from AAA/aaa.

(ii) A's methodology violates the requirement in paragraph (d)(3)(iii) of this section that the same cost or risk not be taken into account, directly or indirectly, more than once. By using a AA/aa discount rate, A's method takes into account the difference between risk-free obligations and AA/aa obligations. This difference includes the difference between a rating of AAA/aaa and one of AA/aa. By adjusting values for the difference between a rating of AAA/aaa and one of AA/aa, A takes into account risks that it had already accounted for through the discount rates that it used. The same result would occur if A

judged some of its counterparties' obligations to be of AAA/aaa quality but A failed to adjust the values of those obligations to reflect the difference between a rating of AAA/aaa and one of AA/aa.

Example 4.(i) The facts are the same as in Example 1, except that A determines the mid-market value for each derivative and then subtracts the corresponding part of the bid-ask spread.

(ii) A's methodology violates the rule in paragraph (d)(3)(i) of this section that forbids valuing the derivatives at or near the bid or ask value.

Example 5. (i) The facts are the same as in Example 1, and, in addition, A's adjustments for all risks and costs, including credit risk, future administrative costs, and model risk, consistently cause the adjusted value to be at or near the bid value or ask value.

(ii) A's methodology violates the rule in paragraph (d)(3)(i) of this section that forbids valuing the derivatives at or near the bid or ask value.

(e) Compliance with other rules. Notwithstanding any other provisions of this section, the fair market values for purposes of the safe harbor must be consistent with section 482 or rules that adopt section 482 principles, when applicable. Thus applicable financial statement values must be adjusted as necessary for purposes of the safe harbor. For example, if a notional principal contract is subject to section 482 or section 482 principles, the values of future cash flows taken into account in determining the value of the contract for purposes of section 475 must be consistent with section 482.

(f) Election--(1) Making the election. Unless the Commissioner prescribes otherwise, an eligible taxpayer elects

under this section by filing with the Commissioner a statement declaring that the taxpayer makes the safe harbor election in this section for all its eligible positions. In addition to any other information that the Commissioner may require, the statement must describe the taxpayer's applicable financial statement for the first taxable year for which the election is effective and must state that the taxpayer agrees to timely provide upon the request of the Commissioner all information, records, and schedules required by paragraph (k) of this section. The statement must be attached to a timely filed Federal income tax return (including extensions) for the taxable year for which the election is first effective.

(2) Duration of the election. Once made, the election continues in effect for all subsequent taxable years unless revoked.

(3) Revocation—(i) By the taxpayer. An eligible taxpayer that is subject to an election under this section may revoke it only with the consent of the Commissioner.

(ii) By the Commissioner. The Commissioner, after consideration of all relevant facts and circumstances, may revoke an election under this section, effective beginning with the first open year for which the election is effective or with any subsequent year, if—

(A) The taxpayer fails to comply with paragraph (k) of this section (concerning record retention and production) and the taxpayer does not show reasonable cause for this failure;

(B) The taxpayer ceases to have an applicable financial statement or ceases to use an eligible method; or

(C) For any other reason, no more than a de minimis number of eligible positions, or no more than a de minimis fraction of the taxpayer's eligible positions, are covered by the safe harbor in paragraph (b) of this section.

(4) Re-election. If an election is revoked, either by the Commissioner or by the taxpayer, the taxpayer (or any successor of the taxpayer) may not make the election for any taxable year that begins before the date that is six years after the first day of the earliest taxable year affected by the revocation without the consent of the Commissioner.

(g) Eligible positions. Eligible positions mean those types or classes of securities or commodities that are marked to market under section 475 and are described by the Commissioner as eligible positions for purposes of this safe harbor in a revenue procedure or other published guidance.

(h) Applicable financial statement--(1) Definition. An eligible taxpayer's applicable financial statement for a taxable year is the taxpayer's primary financial statement for that year if the statement is described in paragraph (h)(2)(i) of this



section (concerning statements required to be filed with the SEC) or if the statement is both described in either paragraph (h)(2)(ii) or (iii) of this section and also meets the requirements of paragraph (j) of this section (concerning significant business use). Otherwise, or if the taxpayer does not have a primary financial statement for the taxable year, the taxpayer does not have an applicable financial statement for the taxable year.

(2) Primary financial statement. For any taxable year, an eligible taxpayer's primary financial statement is the financial statement, if any, described in one or more of paragraphs (h)(2)(i) through (iii) of this section. If more than one financial statement of the taxpayer for the year is so described, the primary financial statement is the one first described in paragraphs (h)(2)(i) through (iii) of this section. A taxpayer has only one primary financial statement for any year.

(i) Statement required to be filed with the Securities and Exchange Commission. A financial statement that is prepared in accordance with U.S. GAAP and that is required to be filed with the SEC, such as the 10-K or the Annual Statement to Shareholders.

(ii) Statement filed with a Federal agency other than the IRS. A financial statement that is prepared in accordance with

U.S. GAAP and that is required to be provided to the Federal government or any of its agencies other than the IRS.

(iii) Certified audited financial statement. A certified audited financial statement that is prepared in accordance with U.S. GAAP; that is given to creditors for purposes of making lending decisions, given to equity holders for purposes of evaluating their investment in the eligible taxpayer, or provided for other substantial non-tax purposes; and that the taxpayer reasonably anticipates will be directly relied on for the purposes for which it was created.

(3) Example. A prepares a financial statement, FS1, that is required to be filed with a Federal government agency other than the SEC or the IRS, and is thus described in paragraph (h)(2)(ii) of this section. A also prepares a second financial statement, FS2, that is a certified audited financial statement that is given to creditors and that A reasonably anticipates will be relied on for purposes of making lending decisions, and that is thus described in paragraph (h)(2)(iii) of this section. Because FS1, which is described in paragraph (h)(2)(ii) of this section, is described before FS2, which is described in paragraph (h)(2)(iii) of this section, FS1 is A's primary financial statement.

(4) Financial statements of equal priority. If two or more financial statements are of equal priority, after applying the rules of paragraph (h)(2) of this section, then the statement that results in the highest aggregate valuation of eligible positions being marked to market under section 475 is the primary financial statement.

(5) Consolidated groups. If the taxpayer is a member of an affiliated group that files a consolidated return, the primary financial statement of the taxpayer is the primary financial statement of the common parent (within the meaning of section 1504(a)(1)) of the consolidated group.

(6) Supplement or amendment to a financial statement. For purposes of paragraph (b)(1) of this section and this paragraph (h), a financial statement includes any supplement or amendment to the financial statement.

(7) Certified audited financial statement. For purposes of this paragraph (h), a financial statement is a certified audited financial statement if it is certified by an independent certified public accountant from a Registered Public Accounting firm, as defined in section 2(a)(12) of the Sarbanes-Oxley Act of 2002, Public Law 107-204, 116 Stat. 746 (July 30, 2002), 15 U.S.C. §7201(a)(12), and rules promulgated under that Act, and is--

(i) Certified to be fairly presented (a "clean" opinion);

(ii) Certified to be fairly presented subject to a concern about a contingency, other than a contingency relating to the value of eligible positions (a qualified "subject to" opinion);  
or

(iii) Certified to be fairly presented except for a method of accounting with which the Certified Public Accountant

disagrees and which is not a method used to determine the value of an eligible position held by an eligible taxpayer (a qualified "except for" opinion).

(i) [Reserved].

(j) Significant business use--(1) In general. A financial statement is described in this paragraph (j) if--

(i) The financial statement contains values for eligible positions;

(ii) The eligible taxpayer makes significant use of financial statement values in most of the significant management functions of its business; and

(iii) That use is related to the management of all or substantially all of the eligible taxpayer's business.

(2) Financial statement value. For purposes of this paragraph (j), the term financial statement value means--

(i) A value that is taken from the financial statement; or

(ii) A value that is produced by a process that is in all respects identical to the process that produces the values that appear on the financial statement but that is not taken from the statement because either--

(A) The value was determined as of a date for which the financial statement does not value eligible positions; or

(B) The value is used in the management of the business before the financial statement has been prepared.

(3) Management of a business as a dealer or trader. For purposes of this paragraph (j), the term management of a business as a dealer or trader refers to the financial and commercial oversight of the business. Oversight includes, but is not limited to, senior management review of business-unit profitability, market risk measurement or management, credit risk measurement or management, internal allocation of capital, and compensation of personnel. Management of a business as a dealer or trader does not include either tax accounting or reporting the results of operations to other persons.

(4) Significant use. If an eligible taxpayer uses financial statement values for some significant management functions and uses values that are not financial statement values for other significant management functions, then the determination of whether the taxpayer has made significant use of the financial statement values is made on the basis of all the facts and circumstances. This determination must particularly take into account whether the taxpayer's reliance on the financial statement values exposes the taxpayer to material adverse economic consequences if the values are incorrect.

(k) Retention and production of records--(1) In general. In addition to all records that section 6001 otherwise requires to be retained, an eligible taxpayer subject to the election

provided by this section must keep, and timely provide to the Commissioner upon request, records and books of account that are sufficient to establish that the values used for eligible positions for purposes of section 475 are the values used in the applicable financial statement. This obligation extends to all books and records that are required to be maintained for any period for financial or regulatory reporting purposes, even if these books or records may not otherwise be specifically covered by section 6001. All records described in this paragraph (k) must be maintained for the period described in paragraph (k)(4) of this section, even if a lesser period of retention applies for financial statement or regulatory purposes.

(2) Specific requirements—(i) Reconciliation. Unless the Commissioner otherwise provides—

(A) In general. An eligible taxpayer must provide reconciliation schedules between the applicable financial statement for the taxable year and Federal income tax return for that year. The required reconciliation schedules include all supporting schedules, exhibits, computer programs and any other information used in producing the values and schedules, documentation of rules and procedures governing determination of the values. The required schedules also include a detailed explanation of any adjustments necessitated by imperfect overlap between the eligible positions that the taxpayer marks to market

under section 475 and the eligible positions for which the applicable financial statement uses an eligible method. A corporate taxpayer subject to this paragraph (k) must reconcile the net income amount reported on its applicable financial statement to the amount reported on the applicable forms and schedules on its Federal income tax return (such as the Schedule M-1, "Net Income(Loss) Reconciliation for Corporations With Total Assets of \$10 Million or More"; Schedule M-3, "Net Income(Loss) Reconciliation for Corporations With Total Assets of \$10 Million or More"; and Form 1120F, "U.S. Income Tax Return of a Foreign Corporation") in the time and manner provided by the Commissioner. Eligible taxpayers that are not otherwise required to file a Schedule M-1 or Schedule M-3 must reconcile net income using substitute schedules similar to Schedule M-1 and Schedule M-3, and these substitute schedules must be attached to the return.

(B) Values on books and records with supporting schedules.

The books and records must state the value used for each eligible position separately from the value used for any other eligible position. However, an eligible taxpayer may make adjustments to values on a pooled basis, if the taxpayer demonstrates that it can compute gain or loss attributable to the sale or other disposition of an individual eligible position.

(C) Consolidation schedules. The taxpayer must provide a schedule showing consolidation and de-consolidation that is used in preparing the applicable financial statement, along with exhibits and subordinate schedules. This schedule must provide information that addresses the differences for consolidation between the applicable financial statement and the Federal income tax return.

(ii) Instructions provided by the Commissioner. The Commissioner may provide an alternative time or manner in which an eligible taxpayer subject to this paragraph (k) must establish that the same values used for eligible positions on the applicable financial statement are also the values used for purposes of section 475 on the Federal income tax return.

(3) Time for producing records. All documents described in this paragraph (k) must be produced within 30 days of a request by the Commissioner, unless the Commissioner grants a written extension. Generally, the Commissioner will exercise his discretion to excuse a minor or inadvertent failure to provide requested documents if the taxpayer shows reasonable cause for the failure, has made a good faith effort to comply with the requirement to produce records, and promptly remedies the failure. For failures to maintain, or timely produce, records, see paragraph (m) of this section (allowing the Commissioner, but not the taxpayer, to use fair market values which clearly



reflect income, but which are different from those values used on the applicable financial statement, for eligible positions that otherwise might be subject to the safe harbor) and paragraph (f)(3)(ii) of this section (allowing the Commissioner to revoke the election).

(4) Retention period for records. All materials required by this paragraph (k) and section 6001 must be retained as long as their contents may become material in the administration of any internal revenue law.

(5) Agreements with the Commissioner. The Commissioner and an eligible taxpayer may enter into a written agreement that establishes, for purposes of this paragraph (k), which records must be maintained, how they must be maintained, and for how long they must be maintained.

(1) [Reserved].

(m) Use of different values. If the taxpayer fails to satisfy paragraph (k) of this section (concerning record retention and record production) with respect to the records that relate to certain eligible positions for a taxable year, the Commissioner may, for those eligible positions for that year, use fair market values under section 475 that are different from those values reported for those positions on the applicable financial statement and are values the Commissioner determines to be appropriate to clearly reflect income. See

paragraph (f)(3)(ii) of this section concerning revocation of the election by the Commissioner, when a taxpayer does not produce required records and fails to demonstrate reasonable cause for such failure.

Par. 4. Section 1.475(e)-1 is amended by redesignating paragraphs (d) through (j) as paragraphs (e) through (k), respectively and adding a new paragraph (d) to read as follows:  
§1.475(e)-1 Effective dates.

\* \* \* \* \*

(d) Effective date. Section 1.475(a)-4 (concerning a safe harbor to use applicable financial statement values for purposes of section 475) applies to taxable years ending on or after the date on which the Treasury decision promulgating these regulations is published in the **FEDERAL REGISTER**.

\* \* \* \* \*

/s/ Mark E. Matthews  
Deputy Commissioner for Services  
and Enforcement.